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TRADE LIBERALIZATION IN CHILE: LESSONS FOR HEMISPHERIC INTEGRATION

by

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1. Introduction.

In the last decade, most Latin American countries transformed from a group of debt-burdened, inflationary, stagnating economies with little international economic links --especially with their neighbors--, into dynamic economies, in which reforms are being implemented, capital has become abundant, and for which the word *integration* conveys an important message of hope for sustained development. During the 1990-93 period, macroeconomic stability has been reestablished, per-capita GDP has grown by 4.3 percent --as opposed to the 8.9 percent of reduction in the previous decade--, and exports have increased from US$ 78 billion to US$ 133 billion.[1] Inflation, for which Latin America has been identified so long, has declined from an annual average rate of 75 percent in 1985 to 19 percent in 1993.

This metamorphosis, perhaps the most important economic phenomenon in the last decades, has been greatly influenced by a global tendency towards market deregulation and government retrenchment. An important influence has been the successful transformation of Chile, once the most conservative import-substitution regime, into a dynamic export-oriented economy. Chile has become a leading example of the widespread benefits, as well as the difficulties, of unilateral trade liberalization and market reform. The pioneering program of trade liberalization and structural adjustment implemented since 1975, led to rapid growth, expanding exports and increased productivity in the tradable and non-tradable sectors in the late 1970s. This early start, however, was dramatically interrupted in 1982, when the cumulative effects of exchange rate mismanagement, falling terms of trade and the debt crisis induced a severe downturn to the economy. After a brief reverse in the reforms in the 1983-84 period, the authorities renewed their effort to modernize and transform the economy, reshaping incentives towards export markets. In the decade of 1985-1994, this strategy has paid off: the economy has experienced a remarkable period of sustained growth, exports have expanded and diversified, inflation has remained under control, and unemployment and poverty have declined markedly.

[1] Includes all Latin American countries, except Cuba, as reported by ECLAC (1994); inflation figures exclude countries with hyperinflationary processes: Bolivia in 1985 (8,170 percent) and Brazil in 1993 (2,244 percent).

This chapter looks at the Chilean experience with trade reform to address two broad issues. First, as Chile initiated the reforms two decades ago, it is useful to discuss the lessons derived from this experience that might be of interest for other countries at an early stage of reforms. A second issue, related to the current wave of trade integration via bilateral arrangements and regional trade pacts (such as MERCOSUR, NAFTA, and CACM[2]), is to explore what are Chile's incentives to join a regional trade pact and what would be Chile's role in the formation of a broad regional trade agreement, as that envisioned in the Summit of the Americas.

The paper is organized as follows. Section 2 reviews the Chilean experience with structural reforms and discusses some of the most important implications for countries in the early stages of their own reform processes. Congruency in the implementation of trade liberalization and its consistency with other macroeconomic policies, emerge as crucial elements for the success of a reform program and to hasten the speed at which it can yield its benefits. The need to bolster and maintain the credibility of reform policies becomes a crucial element in inducing private investment, the key element to maintain high rates of growth, to seize the opportunities emerging from the reform process. A word of caution arises from the fact that the costs of the reforms, in special the cost of policy mistakes, can be quite high in the transition period, particularly in terms of unemployment and/or worsening income distribution.

Section 3 analyzes the main weaknesses of the current economic situation in Chile and discusses the extent to which unilateral trade liberalization can overcome these limitations and the incentives Chile has to join trade agreements. In the Chilean case, trade itself is not the main incentive for joining a pact, as the reforms have already accomplished a high degree of integration to world markets; rather, non-trade factors, such as the reduction in the country's financial risk, a prompt access to new technologies, and a defense against further protectionism in developed countries, appear to be more important determinants in the decision of joining MERCOSUR, NAFTA, or other trade agreements.

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[2] MERCOSUR is the Mercado Común de América del Sur (South-America Common Market) formed by Argentina, Brazil, Paraguay and Uruguay. The North America Free Trade Agreement (NAFTA) includes Canada, the U.S. and Mexico. CACM is the acronym for Central American Common Market.

Section 4 extends the discussion on integration to consider the formation of a Western Hemisphere free-trade agreement (WHFTA), as that proposed in the summit of Latin American, Canadian, and US leaders held in Miami in December, 1994. The creation of a WHFTA was a widely discussed topic since the launch of the EAI in 1990. Nevertheless, the lack of involvement of the US in the region during the 1990-92 period provoked some disillusion among several Latin American countries, which was only mildly dissipated by Mexico's entry to NAFTA in 1993. The unexpected announcement of a deadline for the formation of the free-trade area as early as 2005, changed radically the perception regarding the commitment of the US and the major Latin American countries -in particular Mexico and Brazil- towards free-trade. Although the schedule for the implementation of the agreement was not delineated at the summit, there are indications of two strategies that could be used to achieve full integration. First, existing trade agreements among Latin American countries, once they are fully implemented, are expected to merge in order to form large blocs of countries that would in turn negotiate accession to NAFTA. Second, the invitation of NAFTA members to Chile to initiate negotiations for admission in May 1995 also suggests that the incremental expansion of NAFTA might be possible. This section discusses the advantages and drawbacks of each strategy, as conditioned by political and economic forces at the country and international levels.

Section 5 summarizes the main findings and brings a word of caution regarding the current wave of trade opening and reforms. Although the outlook for Latin America is promising, some recent events advice a prudent assessment of the present situation. Financial flows have eased the implementation of reforms; current account deficits, to be expected as a consequence of trade liberalization, have been easily financed with foreign saving. The increasing instability of the Mexican stock market, the large current account deficit of Argentina, and the financial crisis in Venezuela, however, are signs that the situation in Latin America remains to be consolidated.

2. *Lessons from Trade Liberalization and Economic Reforms in Chile*

The last decade has certainly been the most successful period of economic growth in Chile since the Big Depression of the 1930s. In 1993, the economy completed its ninth year of continuous growth at an average rate of 6.6 percent per year and per-capita GDP reached US$3,200, more than doubling its 1983 level. This vigorous expansion in production has been accompanied by reduced levels of unemployment --which bottomed at 4.6 percent in 1993--, decreasing inflation and poverty levels, and a buoyant external situation. Table 1 presents a set of selected macroeconomic indicators for the 1960-1993 period.

The engine of the spectacular transformation of the Chilean economy has undoubtedly been the trade liberalization program initiated in the mid 1970s.[3] The main reasons for the radical transformation brought about by the trade reforms was the clear failure of the import-substitution

TABLE 1
CHILE: SELECTED MACROECONOMIC INDICATORS, 1960-1993

	GDP Growth (%)	Inflation (%)	Govt. Deficit (%)	Unempl. Rate (%)	Gross Investment (% of GDP)	Curr.Acc Deficit (% of GDP)	Exports (in US$ mn of 1993)	Terms of Trade 1980=100	Average Tariff (%)
1960-64	3.6	23.5	4.7	7.5	15.3	3.9	2,377	83.7	103.9
1965-70	4.1	26.6	2.1	5.6	14.5	1.4	3,891	192.0	66.7
1971-73	0.7	152.1	16.1	4.1	13.5	2.9	3,596	175.2	90.9
1974-81	3.6	163.9	1.6	15.1	15.8	5.0	6,072	121.6	28.4
1982-84	-3.6	19.0	8.5	28.9	13.0	8.4	5,393	83.7	17.3
1985-93	6.6	19.7	1.5	10.0	21.5	3.6	8,160	99.8	16.0

Source: Central Bank of Chile (complete data is presented in Appendix Table 1).

[3]The Chilean economic transformation has been extensively documented by Sjaastad and Cortés (1981), Edwards and Cox-Edwards (1987), de la Cuadra and Hachette (1991), and Bosworth, Dornbusch and Labán (1994).

strategy in providing the basis for sustained growth. The import substitution scheme, implemented in Chile since the 1940s, included high and very differentiated import tariffs (ranging from 0 for capital goods to 750 percent for luxury goods), quotas and import prohibitions, requirement of a 90-day non-interest bearing deposit of 10,000 percent of the CIF value of imported goods, and administrative approval of all import operations. In addition, a system of multiple exchange rates prevailed reaching, at the collapse of the economy in 1973, a proportion of 52 to 1 (Corbo and Fischer, 1994).[4]

By the late 1960s, trade restrictions had practically isolated the Chilean economy from the rest of the world, exacerbating its dependence on copper exports and confining imports to intermediate and capital goods (see Table 2). The structure of relative prices was characterized by important distortions in favor of industrial goods at the expense of agricultural, mining and other tradable activities. Differential import duties exempted capital goods and levied high taxes on final goods, creating a largely inefficient capital-intensive industrial sector. In the macroeconomic front, reliance on money printing to finance large fiscal deficits[5] caused inflation to become a chronic phenomenon; despite several stabilization plans implemented in the 1952-1970 period, average inflation remained at 34 percent per year with a maximum of 84 percent per year in 1955.[6]

Unusually favorable terms of trade during the second half of the 1960s (see Table 1) allowed very expansive fiscal policies, increasing the average growth rate of GDP to 4 percent per year, reducing unemployment, and expanding real wages at an annual rate of 11.2%, well above

[4] A thorough description of the structure of foreign trade before trade reforms is presented in de la Cuadra and Hachette (1991).

[5] The fiscal deficit includes, in addition to the deficit of the government, that of public enterprises. It is a more appropriate measure of the public sector stance when, as in the Chilean case in the 1960-79 period, most public enterprises received large subsidies from the government to cover losses.

[6] Only one stabilization plan, in 1959, included wide-range trade liberalization measures. Expansionary government policies led to overvaluation of the exchange rate, a large increase in imports, and to an unsustainable current account deficit and balance of payments crisis in 1962. In turn, it prompted a large devaluation and a return to capital and trade controls (Velasco, 1994).

TABLE 2
CHILE: COMPOSITION OF TRADE BY GOODS (%)

	1970	1975	1980	1985	1990	1993
EXPORTS						
Copper	75.5	57.4	46.1	46.1	45.7	35.5
Other Minerals	9.9	11.9	13.3	14.8	9.7	7.5
Fisheries*	0.1	2.3	6.2	8.8	10.1	4.0
Agriculture	2.7	8.1	12.7	8.2	11.4	10.9
Forestry**	0.9	4.9	6.0	11.8	3.8	8.0
Industrial Goods	10.8	15.4	15.7	10.3	19.3	34.1
IMPORTS						
Consumption Goods	15.0	28.0	33.7	23.0	13.6	18.1
Intermediate Goods	40.8	52.9	45.6	57.1	55.1	54.7
Capital Goods	44.2	19.0	20.7	19.9	31.3	27.2

Source: Central Bank of Chile (1994).
Notes: (*) includes fishmeal; (**) includes processed derivatives (pulp).

productivity increases. When the Allende Administration took office in 1970 the economy was already out of balance; fueled by the electionary process, government expenditures had expanded 21% in real terms and the fiscal deficit increased to 2.7% of GDP. Annual inflation reached 32% and the foreign trade balance deteriorated markedly, despite increasing quantitative controls. In the following three years, the Allende Administration attempted a transformation of the economy along socialist lines; land reform, bank nationalization and a further expansion of public expenditures were financed by a massive injection of credit. Under increasing social instability, the populist strategy rapidly caused the economy to go out of control; the fiscal deficit reached 24.7% of GDP in 1973; inflation spiralled, surpassing 360% in 1973; black markets multiplied as price controls increased; and GDP, which had grown by 9% in 1971, stagnated in 1972 and collapsed in 1973. In September, 1973 the military overthrew the government in a violent coup d'etat.

The crisis of 1973 marked the culmination of a period of widespread government intervention and generalized lack of confidence in the role of the market, and particularly in foreign trade, as a mechanism to allocate resources and develop a sustainable growth strategy. In the following 15 years, trade liberalization policies were to be the cornerstone of the transformation of the inward-oriented Chilean economy into a dynamic export-oriented country. A brief chronology of the trade reform is presented in Table 3.

The initial set of measures, which included price liberalization, exchange market unification and the elimination of most non-tariff barriers (quotas and prohibitions), was designed primarily with the purpose of stabilizing inflation, eliminate black markets, and reduce speculation. The resistance of inflation to reduce, despite the substantial decline in the fiscal deficit, led the government to apply a drastic program of government austerity and monetary restraint in mid-1975, which effectively reduced inflation from 70% in the second quarter to less than 25% in the third. On the productive side, however, the stabilization effort, coupled with a severe downturn in terms of trade, induced a drastic recession: in 1975, GDP fell by 13.3% and unemployment rates sharply shot up to 17%.

During the 1976-80 period the economy recovered at high speed; GDP grew at an average rate of 7%, the availability of foreign goods expanded markedly, and the government deficit turned into a surplus. In addition, an important number of reforms were initiated to complement and reinforce the change in relative prices induced by trade deregulation: among them, a large number of public enterprises were privatized, labor markets were deregulated, social security was reformed, and health and public education responsibilities were transferred from the ministries to the county levels. Although reforms advanced in several fronts, two major problem remained unsolved: unemployment levels did not decline in a significant way, and inflation remained stubbornly high. Among the instruments used to control inflation, the fixing of the nominal exchange rate in June, 1979 proved to have a devastating effect. The highly indexed nature of the Chilean economy,[7] in combination with the fixed exchange rate, induced an increasing overvaluation in the real exchange rate, fostering imports and discouraging exports, and leading to large current account deficits (see Table 4).[8] In 1981, the latter reached 14.5% of GDP. Large amounts of foreign loans entered the country to finance the trade imbalance and, as a consequence,

[7] Indexation is a mechanism by which prices and wages are automatically adjusted by past inflation to maintain their real level constant.

[8] It has been estimated that by 1981 the exchange rate was overvalued by 21% (Elbadawi and Soto, 1994).

TABLE 3
CHRONOLOGY OF THE TRADE LIBERALIZATION PROCESS IN CHILE, 1973-1993

1973	Price controls on more than 3,000 goods and quota and other restrictions on 2,278 importable goods are eliminated. The multiple exchange rate system is reduced to two rates and a crawling-peg mechanism enacted.
1974	Average tariffs are reduced from 105% to 57%, while the maximum rate drops from 750% to 120%. The administrative approval of imports is eliminated.
	The foreign investment statute is enacted to encourage capital inflow and repatriation.
	The Central Bank announces that tariffs will adjust downward to locate in the 10% to 35% range (the higher rate for manufactured goods) in a two-and-half years period.
	The cascade sales tax is replaced by the value added tax (VAT). Exporters are entitled to rebates on VAT and duties on imported inputs.
1975	Import restrictions and quotas on 3,212 goods are eliminated; only 5 items remained controlled (gold, jewels, Color TV sets, furs and whiskey).
1976	Chile withdraws from the Andean Pact, to allow a further trade liberalization. Tariffs on inputs, intermediate goods, tools and machinery not produced in the country are, unexpectedly, lowered to 10%.
1977	The tariff adjustment planned for 1978 is enacted in advance. Tax surcharges on tobacco, perfumes and other "luxurious" goods are eliminated.
	The government takes advantage of discontent with the 10-35% tariff structure, proposing a 10% flat rate and a 18-month phase-out period for the existing structure.
1978	Import duty exemptions are eliminated.
1979	Tariffs are reduced to a flat rate of 10%. The exchange rate is fixed at $39 per US$.
1982	To confront the crisis, the exchange rate is devalued, tariff are trasitorily increased to 35% and trade and exchange controls reinstated.
1986	Tariffs are reduced to 15% and controls lifted. The capital account is increasignly openned and capital inflows resume.

the foreign debt increased from US$ 6 billions in 1977 to US$14.8 billion in 1981. Two additional elements that help augmenting the level of indebtedness were the resistance of the real interest rate to converge to world levels, and the deregulation of the financial market in 1981. The former induced a continuous flow of short-term lending; the lack of adequate supervision of the quality of the portfolio of banks in the latter, led to a generalized miscalculation of risk levels and imprudent domestic lending.

TABLE 4
CHILE: BALANCE OF PAYMENTS, 1975-1993
(in US$ millions)

	1975-78	1979-1981	1982-1984	1985-1989	1990-1993
Exports	2088	4125	3729	5670	9107
Imports	-2008	-5391	-3259	-4270	-8452
Trade balance	80	-1265	470	1400	655
Current Account Balance	-495	-2631	-1844	-869	-782
Capital Account Balance	716	3370	1221	1071	2385
Foreign Direct Investment	52	291	205	802	1070
Chilean Investment Abroad	14	26	10	8	223
Net Capital Flows	664	3115	1026	277	1579
Reserves Accumulation	207	786	-563	178	1671
Foreign Debt	5550	12667	17767	18400	18170

Source: Central Bank of Chile (1994).

With such a large trade imbalance, confidence in the Chilean economy faltered and foreign lending ceased. In June, 1982 the authorities were forced to devalue the peso by 19%, but "it was too little, and too late" (Edwards and Cox-Edwards, 1987, p. 21). The economy fell in a deep recession as GDP dropped by 13.4% in 1982 and a further 3.5% in 1983; unemployment, already high, skyrocketed to reach 34% of the labor force (including emergency employment programs), and the government deficit increased to almost 9% of GDP when the Central Bank had to rescue the financial sector from bankruptcy. Foreign debt reached 130% of GDP in 1983.

During much of the 1983-84 period economic policy went adrift. Exchange controls were reintroduced, trade restrictions multiplied, and subsidies for financial and industrial firms were allocated on a very discretional basis. Despite the military stronghold, political turmoil emerged.

After expansive fiscal policies enacted in 1984 to cope the hardness of the recession increased inflation and the foreign trade alarmingly, the government returned to a market-based approach in early 1985, engineered a large real devaluation (30%) and embarked the economy firmly into its current export-oriented strategy. Tariffs and restrictions were scheduled to be shortly phased-out, tax incentives for exporters expanded, and government expenditures were reduced aiming at both fiscal austerity and exchange rate support.

The story of Chile in the 1986-1993 period is one of marked success, in which a dynamic tradable sector has become the source of sustained development. Moreover, Chile completed a very difficult transition from military rule to democracy, without a contraction in output or private investment. A crucial element in this transition has been the firm commitment of the newly elected democratic government to maintain and deepen the reforms. As a result, GDP has grown at very high rates (7%), inflation remains under control[9], exports continue to expand and diversify, and unemployment has declined to historical lows. Foreign direct investment has increased to US$ 1.5 billion in 1993, while Chilean investment abroad has reached significant levels (US$ 400 million in 1992 and 1993). As of today, Chile stands as one of the most open economies in Latin America and, probably, the developing countries. With a level of tariffs as low as 11% and absence of non-tariff barriers, it has became a paradigm of trade liberalization.

Lessons of the Chilean Experience

Probably the most important lesson to be drawn from the Chilean experience is the importance of *a systematic effort to implement and deepen the reforms*, despite the natural resistance of those who might be adversely affected by them, and the uncertainty on the outcome of the reforms, arising from shocks to domestic and international markets. As noted above, the early reforms were interrupted abruptly in the early 1980s; amidst the chaos induced by the collapse of the financial sector, import tariffs were raised to 30%, and foreign exchange controls

[9]Inflation, though still high for OECD standards, has been slowly receding and the Central Bank expects it will reach single-digit levels in 1994 (Zahler, 1994).

were re-enacted. Critics of the reform process multiplied and even within the military regime there were voices calling for a return to the import substitution strategy (Velasco, 1994). The de-facto nationalization of an important part of the banking and financial sector also signalled a reversal of the privatization process and a return of the government to productive activities. Nevertheless, the authorities persisted on their objective of keeping the economy as open and de-regulated as before the crisis, and declared its intention of re-privatizing banks and financial institutions (this time under strict regulation). Tariffs surcharges were also defined as temporary and re-scheduled to decline in short time to a level of 15%. Once the foreign debt was renegotiated, exchange controls were lifted. The privatization of public enterprises, which had been suspended during the crisis, was reinvigorated by a generous subsidy to acquire property using foreign debt bonds.[10]

A second important lesson from the Chilean experience is that *a comprehensive program of reforms is necessary* to complement and reinforce the benefits of trade liberalization. The benefits in terms of efficiency and increased growth potential from expanding trade require a sound macroeconomic environment, factor markets freed of restrictions, and an institutional setup that reduces risk for private investment and provides an adequate structure of incentives.[11] The Chilean experience also shows that regulation and supervision of financial activities is crucial to avoid negative externalities and mismanagement of the newly created opportunities.

The Chilean experience also shows that *the costs of the reforms can be very high*. Consequently, measures to ameliorate their adverse effects on vulnerable groups are required to maintain support for the reforms. Although not binding in the Chilean case, political support for the reforms can become a significant constraint in the context of democratic regimes. Labor markets appear to be very sensitive to the massive reallocation of resources stemming from

[10] Serven, Solimano and Soto (1994) present an analytical discussion of the macroeconomic effects of privatization, with emphasis in the cases of Argentina, Chile and Mexico.

[11] The appropriate sequence of reforms and the speed at which these should be implemented is an area in which agreement has not been reached. Conventional wisdom (McKinnon, 1973, and more recently Corbo and Fischer, 1994) argue the need to undertake trade reforms in advance of other reforms (financial, labor markets, etc). On the contrary, Lal (1984) indicates that financial opening is required first, while Krueger (1994) suggests that a simultaneous path increases the ability to cope with the political pressures imposed by trade liberalization and structural reforms.

changes in relative prices; unemployment rates in Chile remained considerably high during most of the reform period (over 15% between 1975 and 1985), inducing a severe cost for the most vulnerable groups in society, and severely deteriorating income distribution (Marcel and Solimano, 1994). Likewise, the downsize in government's activities involves reducing important subsidies to health, education and housing, a space which is not usually covered by the private sector.

Structural adjustment, by nature, includes a re-design of the role of the government. The retrenchment of the government from productive activities, the liberalization of goods and factor markets, and the elimination of administrative controls usually present, in addition to its potential benefits, the risk that the private sector deviates towards non-competitive practices. Therefore, *adequate regulation is important*. This becomes a very difficult balance act between market supervision and outright intervention; in the Chilean case, financial deregulation in the early 1980s was not accompanied by the proper supervision and led to a fragile and highly indebted financial sector. The direct cost of the financial collapse and bail-out of financial institutions by the Central Bank has been estimated at around 10% of GDP (Larrañaga, 1989).

Credibility on the reform strategy and the government's ability to implement it is another element that plays a crucial role in the success of trade liberalization and structural transformation. The success of reforms hinges, to a great extent, in inducing the private sector to switch away from low-profit, inefficient or socially non-productive activities (such as rent-seeking) towards areas which are highly efficient. In order to accomplish this switching, investors need to be sure that reforms are credible; as Chile and other developing countries have learnt, however, this is a slow process.[12] Private investment in Chile did not expand as the economic authorities expected in the mid and late 1970s and most of the 1980s (see Table 1). Only after 1989, investment rates reached a level compatible with high long-run growth rates. In this respect, policy mistakes can be very costly: the use of the nominal exchange rate to control inflation in Chile in the 1979-82

[12] Meller (1994) notes that, although reforms can boost credibility, the link is far more subtle. The massive reforms of the 1970s did not bolster credibility on the government's ability to control inflation, even after most reforms had been undertaken and fiscal surplus achieved. On the contrary, the financial collapse of the early 1980s did not lead agents to inflationary expectations, despite the massive devaluation and fiscal imbalances in the order of 8% of GDP.

period was a disastrously myopic policy, as the cost in terms of export competitiveness and credibility largely outweighed the benefit of reducing inflation. Pindyck and Solimano (1994) show that the slow response of private investment after stabilization can be understood as an option (i.e., a wait-and-see strategy) to reduce the investment risk arising from the fact that, once capital is installed, it usually becomes irreversible.

A final, and perhaps obvious, lesson from the Chilean experience is that *foreign trade can be a source of sustained growth* for Latin American countries, as it has been for East Asian economies. Between 1975 and 1993 total exports have expanded from US$ 1.5 billion to US$ 10 billion, despite the largely depressed terms of trade; non-copper exports increased from less than US$600 million to US$ 6 billion, at an average real growth rate of 9.5% per year. Moreover, diversification in terms of partners have also been achieved (see Table 5). Asian markets, beyond Japan, are currently an important destination for exports and an increasingly attractive source of imports.

To assess the importance of trade opening in the Chilean case, Krueger (1994) suggests the following counterfactual exercise. Imagine that, instead of reforming the economy along the lines described above, the authorities had engaged in a successful stabilization program and most

TABLE 5
CHILE: COMPOSITION OF TRADE BY PARTNER (%)

	Exports		**Imports**	
	1970	**1992**	**1970**	**1992**
United States	14.3	16.3	36.9	20.5
European Community	60.9	29.0	35.3	19.0
Asia	12.1	30.5	3.1	18.1
- of which, Japan	12.0	16.9	3.0	10.0
Latin America	11.4	16.0	22.1	24.7
- of which, MERCOSUR	8.5	10.1	13.4	18.3
Other	1.4	8.3	0.6	17.6

Source: Central Bank of Chile (1994).

reforms undertaken except trade liberalization: how likely would have been to observe the same dynamic growth rates within the bounds of a mostly closed, import substitution economy?

. *The Weaknesses of the Chilean Economy and the Role of Foreign Trade*

Despite its successful experience with reforms, important weaknesses remain in the Chilean economy. These can be overcome by an appropriate trade policy. First, the capacity of the economy to grow based on the expansion of the domestic demand is limited by its reduced size and the absence of important scale economies. Therefore, in order to sustain high growth rates, a further deepening of the integration with international markets is necessary, in particular to diversify exports in terms of goods and partners. Diversification of the structure of exported goods is necessary to reduce the dependency of the Chilean terms of trade on the behavior of the price of copper. As of 1993, copper still amounts to more than 35% of total exports (see Table 2), so that the large fluctuations that characterize the behavior of copper prices induce a marked variability on the terms of trade, as can be seen in Table 1.[13] To reduce the dependence of foreign trade on the fluctuations of commodity markets, it is necessary to increase exports of manufactures and, in particular, to expand the volume of financial and non-financial services (e.g., tourism and computer software) that can be sold abroad. Exports of non-financial services had increase at an average rate of 17% per year since 1984; as of 1993 they amount to US$ 2,634 million (25% of total exports) and for the first time in history the balance in non-financial services exhibited a surplus in that year.

Further diversification in terms of commercial partners is also desirable. Concentration in a few trade partners, as was the case in Chile during the 1960s and 1970s, is associated to excessive risk and impedes profiting on the expansion of other regions or countries. Chilean exports have diversified markedly since trade liberalized, and the ability of exporters to penetrate

[13] The large fluctuations of copper prices have important effects on the government budget, for which copper taxes and profits are a crucial source of revenue. Chile has implemented a stabilization fund which ameliorates in part these adverse fluctuations; as of 1993, the fund has reached a level over US$ 700 million.

East Asian markets and benefit from the rapid expansion in this geographic area has been remarkable (see Table 5). In 1970, 12% of total trade (US$ 145 mn.) was directed to Japan and East-Asia; as of 1992 it has increased to 31% of total trade (US$ 3,086 mn.); on the other hand, the share of exports of European countries declined from 60% to only 29% in the same period. Nevertheless, the large concentration of some goods into specific areas (e.g., fruits to the highly regulated markets of the U.S. and the OECD), induces a certain degree of instability and fragility to exports, in particular for agricultural goods.[14]

In addition, the inadequate level of human capital and physical infrastructure has been signalled as the second main limitation for sustained growth. The administration that took office in 1994 has declared its commitment to a large effort in education and training, as well as an aggressive program of public works to improve transportation (only 10,000 miles of roads are paved), ports and airways, communications, etc. (Jadresic, 1994). In part, the reduced availability of physical infrastructure was inherited from the 1960s and 1970s, but to an important extent it is the consequence of the structural adjustment the economy went through during the reform period and after the 1982-83 crisis. It is important to note that for most of the reform period, investment rates were generally below 15% of GDP (see Table 1), and that public investment, which corresponds mostly to infrastructure, did not reach 5.5% in the 1978-85 period.[15] To maintain the dynamism of the tradable sector, it is important to develop infrastructure, to provide an adequate support for the private sector to allocate resources to profitable activities.

A third element that would hamper high growth levels in Chile is the insufficient investment in technology and know-how. It is well known that developing countries benefit from the technological "catch-up" of developed countries by acquiring successfully applied technologies and avoiding the cost of testing others that are inadequate. Nevertheless, once these scale economies are exhausted, investment in research and development (R&D) becomes an important

[14] In 1989, U. S. imports of Chilean fruits were suspended for 2 months after allegations that a shipment of grapes had been poisoned. Losses for Chilean exporters have been estimated at 1.5% of GDP.

[15] In comparison, public investment in East Asian countries was on average 10.5% of GDP in the same period (World Bank, 1993).

determinant of the country's long-run growth. In the case of Chile, although scale economies may have not been fully utilized, investment in R&D (around 1% of GDP) is still very low for international standards or compared to most high-growth economies, in which it is usually over 3% of GDP. The lack of technological renovation, combined with a relatively unskilled labor force, puts a limit to the diversification of Chilean exports into goods of higher value added, and can lower growth rates.

Given the limited availability of human and financial resources to develop new markets and products, the selection of potential "winners" becomes a key element to sustain high growth rates. To date, the Chilean authorities have opted for a hands-off approach, leaving all initiative to the private sector. Although this strategy has been successful, the above mentioned exhaustion of the technological catch-up suggests there is an increasing cost of wrong decisions. The successful experience of East Asian countries with technological innovation, however, needs to be examined in order to determine the extent to which it is possible to combine public and private effort to develop new export markets. Contrary to the historic Latin American experience, some East Asian governments (e.g., Korea, Taiwan) have had the ability of identify and take advantage of the windows of opportunity to develop specific industrial areas, such as electronics and ship-building (World Bank, 1993). It remains to be explored whether the current Chilean policy is optimal or if it is necessary to design a mechanism which allow the private sector to reduce the expected cost of developing new export markets.

The Role of Trade Agreements for Chile

Foreign commerce plays a crucial role in the Chilean development strategy. Non-economic determinants of trade appear to be on the rise, indicating a need to secure exports and imports markets beyond what unilateral trade liberalization by itself can achieve. Trade agreements, as long as their benefits do not derive mainly from trade diversion, are important in this respect.[16]

[16] Trade agreements between two countries have a positive outcome (trade "creation", or the increase in trade as resulting from lowering barriers) and a negative outcome (trade "diversion", or the cost from eliminating competition

In the last decade they have become increasingly important, as two seemingly opposite tendencies have began to emerge in world markets. First, as more countries are reducing protection and liberalizing their economies (Argentina, Mexico, East-Asian and East-European countries) and technological improvements allow fast and cheap communications, there has been a general tendency towards a globalization of international markets. On the other hand, however, trade has become increasingly concentrated in geographic areas, such as the European Community, NAFTA, Japan and East-Asia (Frenkel, Stein, and Wei, 1994). The first tendency indicates that world markets are becoming more competitive and that Chilean exporters need to increase their efforts to maintain their competitiveness and share of the markets. The prices of the principal export goods in fact fell significantly in the last five years (33% copper, 20% fishmeal and 52% pulp). The second tendency warns that the privileges granted to those countries already members of a trade bloc may eventually displace Chilean exports.

The latter effect is probably more worrisome in the case of Chile and it explains the interest of the Chilean authorities to enter lengthy negotiations and lobbying with neighbor countries and members of NAFTA, MERCOSUR and, more recently, the Asian Pacific Economic Cooperation forum (APEC). Since 1990, Chile has signed a significant number of trade agreements with Latin American countries (Mexico, Argentina, Colombia and Venezuela); although it may be premature to try to assess their impact, the early evidence suggests an important response in trade volumes (Chilean exports to Mexico increased from US$ 44 mn in 1992 to US$ 131 mn in 1993). It is unlikely, however, that Chile would join MERCOSUR (except on a special status described below), despite the fact that the regional pact could guarantee access to a large market (190 million of inhabitants and combined GDP of around US$ 400 billion). The main reason has to do with the macroeconomic situation and trade status of MERCOSUR members. First, reforms in the two major country members have either not started yet (Brazil) or are still in an infant stage (Argentina), and macroeconomic stability has not been achieved. Although Argentina is at a promising stage, it has a long way to go before reforms are

from more efficient third countries not included in the agreement).

consolidated, and more structural adjustment in the economy may be required to overcome the fragile external situation (in 1993 the increasingly overvalued real exchange rate has pushed the current account deficit above 6.5% of GDP). On the other hand, Brazil is in an even earlier stage, beginning to stabilize its economy (after a dramatic decline, inflation picked up in the last quarter of 1994) and reforms, in particular trade liberalization and fiscal restructuring, have not been undertaken. Chilean authorities fear that closer economic ties with these countries might prove short-lived and induce instability to the economy.

Secondly, the benefits to Chile from a trade agreement with MERCOSUR may be substantially lower than its costs, if they would mean to reverse its trade liberalization process. Tariffs with the rest of the world would increase in Chile from its current level of 11% to the common MERCOSUR level of 30%. Because trade with MERCOSUR countries is reduced (10 to 15% of total trade) such raise in tariffs would increase average protection levels in Chile substantially. In addition, it is not clear that the agreement would cover all goods (e.g., automobiles are excepted from the common tariff), which in turn could create major domestic price distortions. Furthermore, Argentina and Brazil may not be willing to let Chilean exports to access their markets at a zero tariff rate, because its impact on specific domestic producers would be significantly negative, due to the higher efficiency of Chilean producers in areas such as fruits, fishmeal, or pulp.

The most important reason is, however, that what Chile needs from a trade agreement will not be fulfilled from joining MERCOSUR. Massive technological transfer is unlikely to be obtained from Brazil or Argentina, except in selected sectors and probably not in manufactures or services. Likewise, MERCOSUR will not induce a more diversified portfolio of exports --as the demand for Chilean industrial goods will probably be reduced--, nor a reduction in the country risk arising from volatile terms of trade.

There are, however, important reasons why Chile would prefer to maintain links MERCOSUR, although without explicitly joining it. By the end of 1994, most privileges granted to Chilean exports by MERCOSUR members in the context of ALADI will phase out, and Chilean producers will lose an important concession when exporting to these countries. Under the special status of "non-member commercial partner" Chile may retain in part these advantages. A second incentive to maintain a fluid relationship with Argentina and Brazil is in order to ensure the security of the important volume of Chilean investment in Argentina and Brazil; during 1992 and 1993, more than US$ 800 mn have been invested abroad, mostly in Argentina, Brazil and Peru. A third and more strategic factor, is to leave the long-run option on becoming an important partner of both countries open, in the event the reforms in MERCOSUR countries consolidate and the general economic situation improves.

The case of NAFTA differs significantly from that of MERCOSUR. Casual evidence on the large effort undertaken by the Chilean government and the private sector to join NAFTA and/or sign a FTA with the U.S., would suggest that there are important direct gains from entering into these pacts. On the contrary, it is estimated that Chile has little to gain in direct terms and in the short-run from an FTA with the U.S., since Chilean exports are subject to an average import tariff of only 1.8% and 60% of total exports are affected by a tariff of less than 0.7% (Butelmann and Frohman, 1991). A study by Valdés (1992) calculates that the welfare impact of a Chile-US FTA would amount to slightly more than US$300 million or 1% of GDP, in present value. Exports would increase in as much as 4.5% (US$60 millions), while imports would increase by 27% (US$376 millions). Manufactures exported to the U.S. (30% of total) would benefit from avoiding the step-tariff system already in use, and it is estimated that they might expand by 8%.

The advantages of joining NAFTA are mostly strategic and concern (1) the fear that a protectionist wave in the U.S. might reduce the access to the American market; (2) a likely decline in the country's risk-premium, which in turn would make credit and investment less expensive; (3) an potential reduction in the cost of technology; (4) an eventual expansion of foreign investment in the form of joint ventures; and (5) there may be important dynamic advantages in the form of developing new markets for goods that currently face increasing tariffs and non-tariff restrictions and that, consequently, do not export significant amounts to the U.S.

4. *Trade Liberalization: a Hemispheric Perspective*.

In December 1994, leaders of 33 Latin American countries and the US met in Miami for what is, doubtlessly, the most significant step towards hemispheric integration in history. Unexpectedly and despite the initial reluctance of the three largest economies (Brazil, Mexico, and the US[17]), countries succeeded in setting a date --the year 2005-- for achieving a free-trade agreement including all Latin American countries (except Cuba), Canada, and the US. As a demonstration of its commitment to achieve such goal, the Clinton Administration announced that it will initiate negotiations with Chile for her admission to NAFTA in May 1995.

Although the announcement of a deadline to achieve a WHFTA came as a surprise, the idea that the current wave of trade liberalization and market reforms might converge to the creation of a large trade union, had been taking form since the launch of the EAI in 1990 (Bouzas and Lustig, 1992). Despite its failure at forming a large umbrella for regional trade, the EAI sparked the enthusiasm of Latin American countries into forming new trade unions (such as MERCOSUR, the Colombia-Venezuela-Mexico Trade Accord, etc) or revitalizing existing arrangements (e.g., the CACM). The relatively short horizon agreed to reach full integration -ten years- reflects the degree at which Latin American countries have realized that integration to an increasing global economy is a window of opportunity to modernize their economies that should not be missed.

Two additional elements have had an important effect in the decision of accelerating integration. First, the current international situation is perhaps the most favorable scenario for opening the economy, as substantial foreign resources are available to counterbalance potential trade deficits arising from the implementation of reforms (Calvo et al, 1993). Second, political support for the reforms, both domestic and international, may be at its highest point in decades. The completion of the Uruguay Round negotiations of the GATT, and its swift approval in the US

[17] US Administration officials acknowledged that they were reluctant to set a date. The change in US policy, undertaken within a week from the summit, was motivated in part by the tardy ratification of the GATT in the US Congress, but also as a response to pressures by Latin American countries (The New York Times, p. A8, Dec 7).

Congress in November 1994, are clear signs of the willingness of developed countries to reduce protection and engage in free trade. In the Latin American front, the experiences of Argentina, Costa Rica and Peru, which have succeeded in maintaining popular support for reforms, amply demonstrate the feasibility of making trade and structural reforms a politically attractive strategy.

In spite of this politically favorable scenario, the successful formation of a regional trade agreement depends mostly on economic factors. First, though several Latin American countries have initiated trade reforms, other structural reforms (such as privatization of public enterprises and market deregulation) either have not been implemented or remain to be consolidated. Chile's experience with economic transformation shows that comprehensive reforms are necessary to achieve a lasting liberalization of foreign trade. If comprehensive reforms at the country level are not undertaken, trade liberalization will be unsustainable in the long run, and trade agreements in Latin America will probably be as inconsequential as previous pacts have been.[18] In this sense, sub-regional pacts or NAFTA should not be expected to provide an impulse for trade integration that would substitute the need for comprehensive trade reforms.

Second, the lack of a schedule for negotiations and the heterogeneity of Latin American countries in terms of the implementation of reforms and the removal of trade barriers, suggest that there remains important obstacles to integration. Despite the political willingness of Latin American leaders, the necessary harmonization of economic interests among countries will certainly require lengthy negotiations. Likewise, merging existing trade agreements will probably be cumbersome, as they differ markedly in terms of objectives and programmed schedules. Free trade agreements (such as the Chile-Mexico pact) require only setting of a common tariff level for those goods traded among members of the pact; trade unions (e.g., Andean pact), in addition, oblige country members to set a common tariff for other non-member countries; while common markets (such as what was proposed initially for MERCOSUR) include the liberalization of factor markets (labor and financial markets). Moreover, existing agreements have different schedules for

[18] For a thorough analysis of the failure of trade pacts in Latin America in the 1955-1990 period see Rosenthal (1993).

implementation; while MERCOSUR countries are expected to abolish tariffs in early 1995 the CACM and Andean Pact are to be fully implemented much later.

If, on the other hand, integration is to be achieved by the incremental expansion of NAFTA, there remains to be determined what will be the requirements for admission. The eventual entry of Chile clearly puts a high standard for the rest of the Latin American economies; most countries will have to undertake important measures to achieve this "floor" before applying for admission. Even if the requirements are eased, this strategy may be inefficient for achieving integration as it puts a large proportion of the costs onto Latin American countries, most of which have limited resources available to finance the liberalization of their economies. As such, this strategy assigns a very passive role to NAFTA members, in particular the U.S., which mainly have to wait for Latin American countries to reach the required level of maturity in their reforms to be able to meet the standard.

Third, the creation of a successful WHFTA depends to a large extent on the participation of the 3 largest Latin American economies (Argentina, Brazil, and Mexico) and the provision of temporary relief for small economies. Regarding the participation of the largest economies, Mexico is already a member of NAFTA and Argentina have implemented an important number of trade and structural reforms to become an attractive commercial partner. The current performance of Brazil suggests, however, that the likelihood of a hemispheric trade union is remote in the short run. The Brazilian economy, which accounts for one half of Latin America's GDP, has long been under fiscal mismanagement, hyperinflation and heavy government intervention; a successful reversal in this trend will likely require a lengthy period of time.

When considering the case of the small countries, a successful hemispheric integration also requires provisions for those economies which cannot openly compete with more developed countries in a fully integrated market. Signs that Caribbean countries fear that their economies could suffer greatly from the WHFTA were already present at the Miami Summit; the Prime Minister of Barbados warned that "a rising tide can also overturn small boats"[19]. Exports from

[19] The New York Times, p. a35, Dec. 12, 1994.

most small Caribbean economies currently enjoy preferential access to the US market, an advantage that will disappear after the WHFTA is implemented. Consequently, temporary relief for these economies will probably be necessary for a smooth transition.

A final element that will be crucial in achieving the WHFTA is the development of political events within the US. The 1994 Miami Summit lifted most apprehensions regarding the political will of the US, and in particular of the Clinton Administration, towards fostering free-trade with Latin America. When inviting Chile to initiate discussions to join NAFTA, the Clinton Administration has considered that swift ratification from the Congress can be achieved. As discussed in section 3, the small Chilean economy does not represent a threat for American producers or workers; consequently, opposition in the Congress is expected to be minor. The narrow ratification in the case of Mexico shows, however, that negotiation with the Congress can become quite cumbersome when the pact is expected to have significant effects. The recent Republican victory may have further reduced Clinton's scope for policy manoeuvre because in order to obtain support from Republicans for the ratification of the trade agreements, side arrangements on labor and environmental issues will have to be dropped, irritating Democrats which have based their support to NAFTA precisely on those elements.

5. Conclusions

Trade reform and market deregulation have become an important feature of economic policy in Latin American countries in the last 5 to 10 years. After several decades of pursuing import-substitution strategies, which confined growth to the expansion of the domestic demand, Latin American countries have turned towards foreign trade as a source for sustained growth. In turn, this new strategy has raised a number of issues regarding integration to world markets and the role of regional trade agreements in fostering the transition period.

Chile is, undoubtedly, a pioneer among Latin American countries in trade liberalization and market reforms. The path to achieve this position, however, has been a lengthy and "rocky" road (Taylor, 1993). After a successful start in the late 1970s, the economy fell into distress during the 1982-83 crisis; high unemployment, contracting output, financial collapse, and a surge in inflationary pressures led critics of the reforms to suggest a return to protective practices. A firm commitment towards maintaining the reforms and confidence in the ability of the private sector to overcome the crisis, however hard in the short run, proved to have important long-run benefits. During the last decade the economy has grown at almost 7% per year, exports doubled and unemployment rates receded to less than 5%, and the economy transformed into a dynamic, export oriented economy.

This chapter explored the Chilean experience with trade liberalization and structural reforms and addressed two broad issues. First, we analyze what are the lessons to be drawn from almost two decades of market reforms, that could be useful for countries at the beginning of the reform process. In particular, we discuss to what extent foreign trade can become a source for sustained growth. Second, we analyze the pattern of integration with world markets and neighbor countries that is achieved by a unilateral trade liberalization process. In this case, we explore the incentives Chile has to join trade agreements and what role could Chile play in the formation of an ample trade agreement in the region, inclusive of the U.S. and Canada, as those which have recently been proposed.

Among the lessons to be derived from the Chilean experience, the need of a systematic effort to implement and deepen the reforms, the important complementary effect of other reforms (financial, labor markets, etc), and the crucial role of credibility in reform measures, appear to be most important. In addition, the cost of the reforms for the most vulnerable groups in the society and its political repercussions, are an important consideration when assessing the support for reforms.

Regarding integration with international markets, the Chilean case is a remarkable success. Sustained trade expansion and adequate diversification of exports in terms of goods and partners, however, lower Chile's incentives to join trade agreements. As the short run gains for Chile from trade pacts are small, dynamic considerations (such as securing long run foreign investment, easing the adoption of technology and know-how, declining country risk) become key aspects of its trade strategy. Regional pacts, such as MERCOSUR, do not fulfill Chile's interests in these aspects, and explains her lack of interest in joining them.

The Summit of the Americas held in December 1994, produced two important results regarding integration in Latin America and the eventual formation of a Western Hemisphere free trade zone: a deadline for the integration of all Latin American countries (except Cuba), Canada, and the US (in 2005), and an invitation to Chile to initiate negotiations for admission to NAFTA in 1995. The mechanism and schedule to achieve full integration were not delineated at the Summit, but there were indications that it could be achieve by incremental expansion of NAFTA and/or by merging existing trade pacts. The latter strategy faces the formidable task of harmonizing the heterogenous status of Latin American countries in terms of economic interests, reform implementation and degree of trade liberalization. The incremental expansion of NAFTA is also possible, as exemplified by Chile. The Chilean case, nevertheless, is not representative of the situation of Latin American economies, and it is unlikely that she will become the benchmark for accession to NAFTA, as it sets a high hurdle for other Latin American countries.

Whichever strategy for integration is finally selected, an element that will certainly shape the structure of the WHFTA is the political environment within the US at the moment of negotiations. The recent Republican victory may have further reduced Clinton's scope for policy manoeuvre because in order to obtain support from Republicans for the ratification of the trade agreements, side arrangements on labor and environmental issues will have to be dropped, irritating Democrats which have based their support to NAFTA precisely on those elements.

A final caveat on the current regional integration wave, is that one should be careful in assessing the robustness of the process. It is possible that a significant part of the enthusiasm for implementing trade openness responds to a rather unusual availability of foreign exchange, due in part to the reform process of LA countries, but also importantly to the international situation. The massive inflow of capital to Latin America has allowed countries to lessen restrictions on imports and to be able to finance large trade imbalances; were these flows to revert, several countries would find themselves in a very unfavorable external situation which would raise incentives to increase protection and halt the reforms. The Chilean experience to this respect is explicit; after benefiting from cheap foreign saving in the late 1970s, the subsequent 1982-83 crisis led to a partial reversal of reforms and increased protection. An important effort had to be devoted to undertake the structural reforms required to rescue to economy from the crisis and, at the same time, to return to the correct trade liberalization path.

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